INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/40

10:30 a.m., March 3, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
C. H. Dallara	M. Lundsager, Temporary
	G. Ercel, Temporary
	M. Arif, Temporary
	H. Kobayashi, Temporary
G. Grosche	
	Yang W., Temporary
J. E. Ismael	
	H. A. Arias
	M. Foot
H. Lundstrom	H. Fugmann
	L. Leonard
	P. E. Archibong, Temporary
	J. E. Suraisry
	G. Ortiz
	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	S. King, Temporary
	B. Tamami, Temporary
	A. Vasudevan, Temporary
	N. Coumbis

L. Van Houtven, Secretary
K. S. Friedman, Assistant

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Also Present

H. Brown, Governor of the Bank of Jamaica. IBRD: S. Voyadzis, Latin America and Caribbean Regional Office. Asian Department: K. Saito, I.-S. Kim. European Department: B. Rose, Deputy Director; S. Mitra. Exchange and Trade Relations Department: E. H. Brau, A. Chopra, G. Hacche, G. G. Johnson, S. Kanesa-Thasan, P. M. Thomsen. External Relations Department: A. F. Mohammed, Director. Fiscal Affairs Department: R. D. Kibuka, V. P. Gandhi. Legal Department: P. L. Francotte, J. K. Oh, J. S. Powers. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; D. L. Budhoo, M. Caiola, L. A. Cardemil, D. A. Citrin, L. E. Escobar, J. Fajgenbaum, J. Ferrán, K. Flug, J. P. Guzman, M. E. Hardy, S. C. de Sosa, S. J. Stephens. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, G. Nguyen, A. Ouanes, G. W. K. Pickering. Assistants to Executive Directors: A. Bertuch-Samuels, B. Bogdanovic, G. D. Hodgson, L. Hubloue, J. E. Rodríguez, B. D. White.

1. MESSAGE OF CONDOLENCE

The Chairman said that he had sent a message of condolence on the part of the Fund to the Swedish Government on the death of Prime Minister Palme.

2. JAMAICA - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION; AND EXCHANGE SYSTEM

The Executive Directors considered the staff report for the review under the 22-month stand-by arrangement for Jamaica approved on July 27, 1985, together with proposed understandings on the circumstances in which purchases could be resumed under the arrangement, and a proposed decision on Jamaica's exchange system (EBS/86/26, 2/3/86; Cor. 1, 2/27/86; and Sup. 1, 2/28/86).

The staff representative from the Western Hemisphere Department noted that on February 28, 1986 the staff had circulated a supplement to EBS/86/26 containing information on the financial outturn in December 1985 and January 1986. Since then, the staff had obtained information on the tax reforms in Jamaica that had been announced during February 1986 and that had taken effect from January 1, 1986. The staff had not been directly involved in the tax reform effort, which had benefited mainly from the work of consultants financed by the U.S. Agency for International Development, and the staff had not yet received a copy of the new tax legislation.

The reforms included changes in the personal income tax, the staff representative continued. The previous personal income tax rates, which had ranged up to a maximum marginal rate of 57.5 percent for income in excess of J$14,000--which was equivalent to about US$2,500--were to be replaced by a flat tax at a rate of 33 1/3 percent on incomes in excess of J$8,750. At the same time, tax exemptions for interest income, capital gains, and dividends had been abolished, and benefits such as housing and travel allowances would be included in the taxable income base. The tax reform was intended to be revenue neutral: even if no improvement in tax coverage and compliance were assumed, there would be a reduction in revenues from the new tax rates estimated at around J$180-200 million, equivalent to 1.7 percent of GDP; however, that revenue loss was projected to be offset by widening the tax base, mainly by a withholding tax on interest income that was estimated to yield revenues of around J$170 million a year.

The estimates of the collections from the withholding tax on interest income appeared to be reasonable, the staff representative remarked. For example, at the end of 1985, savings deposits at commercial banks and nonbank financial institutions had been nearly J$2.9 billion. Annual interest payments on those deposits was estimated at around J$0.5 billion, and the withholding tax of one third on that amount would yield some J$170 million in revenues. In light of the possibility that the introduction of taxes on interest earnings might discourage financial saving, the staff had urged the authorities to seek to maintain positive real interest rates.

Those first steps in the tax reform that had been described were to be followed later in 1986 by revisions of the property tax and by the introduction of a general consumption tax that would consolidate the present consumption, sales, and some excise taxes, by revisions in the import tax structure, and by revisions in corporate taxation, the staff representative from the Western Hemisphere Department said. The staff intended to analyze further the likely effects of the reforms during its consideration of the fiscal program for FY 1987.

Mr. Leonard made the following statement on behalf of Mr. Massé:

The year 1985 was extremely difficult for the Jamaican people and the Jamaican economy. Despite strong adjustment efforts over a number of years, the goal of a sustained economic recovery which could benefit all of the Jamaican people has continued to elude the authorities. The slippages over the last year are linked to a considerable degree to a number of external factors beyond the control of my authorities. Among these developments, the significant erosion of the bauxite/alumina sector has been particularly onerous. Even though a deterioration in the sector was anticipated in the program, the actual outturn shows even further weakening. Since 1980, bauxite production has fallen from 12 million tons to less than 6 million tons in fiscal year 1985/86. When combined with a weakening of bauxite prices over the same period, this halving of bauxite production has resulted in a steep decline in bauxite/alumina exports to but one third of their 1980 value. Similarly, following social unrest that occurred in January 1985, triggered by an increase in petroleum prices linked to last year's adjustment program, monthly tourist arrivals have dropped, with a serious impact on net foreign exchange earnings.

The difficulties arising from a higher than programmed current account deficit linked to the weakness in bauxite and tourism were compounded by a shortfall in official capital inflows of roughly US$40 million. This shortfall reflected slower than expected disbursements of project-related loans and delays in certain U.S. economic support flows.

In the face of these circumstances, my Jamaican authorities' serious concern over the country's social and economic situation was heightened in the latter part of 1985, particularly as a pattern of layoffs and redundancies spread across the economy. Because of the large depreciation which had occurred already in the value of the Jamaican dollar, and in view of studies undertaken in Jamaica which indicated that an exchange rate value of J$5.50 to the U.S. dollar was one which established export competitiveness, my authorities were extremely concerned about the serious overshooting taking place in the value of the U.S. dollar. After discussions with the Fund staff, it was agreed that the Jamaican authorities would put into place the demand management policies which would deliver an exchange rate of J$5.50 per U.S. dollar. In taking this action, my authorities understood well the considerable strengthening of the adjustment effort which would be required. I believe that the measures taken over the previous few months, which are outlined in the staff report for discussion today, reflect the strong commitment of the authorities to take the difficult complementary measures which will support their exchange rate policy.

Measures to raise government revenues by some J$100 million for the period January-March 1986 were implemented in early January, and included tax increases on a variety of goods, the elimination of tax exemptions for certain public enterprises, nonrecurring conversion fees on motor vehicle licenses and new revenue collection arrangements. Liquidity conditions in the economy have been tightened further, and my authorities are prepared to carry out further open market operations as required in order to comply with the end-March program target for base money.

My authorities also concluded that there was no alternative to a major improvement in supply-side policies as a companion to broad-based demand management. In order to establish the policies to restore growth, improve stability, maintain competitiveness and pursue the other main objectives of the Fund program, the Prime Minister has invited a tripartite mission made up of representatives of the World Bank, U.S. AID, and the Fund to review urgently the Jamaican program with a view to providing fresh eyes to the difficult Jamaican case. I am happy to note that the Fund and the other institutions have responded quickly and are now working on their report. It is expected that their work will be finished toward the end of March. My authorities are attaching great importance to the mission's findings and recommendations, as it is their belief that this mission will provide a good basis for strengthening and broadening their adjustment effort.

It is against this background that the current waivers and modifications requested by my Jamaican authorities need to be evaluated. I would emphasize that the Jamaican authorities have taken great strides to meet the program's objective indicators at the end of January 1986. Despite a wide number of difficult measures which had to be undertaken with great dispatch, the authorities have met with success in attaining these targets. Thus, they have been able to recover much of the ground lost through slippages which occurred late last year. Moreover, they are committed to meeting the program's performance criteria at the end of March 1986, and by that time the program will be back on the original track which was negotiated last spring. Over the next few months, my Jamaican authorities are proposing to work with the Fund on defining policies and quantitative performance criteria for the remaining 12 months of the program, shaped by the findings of the tripartite mission.

Before concluding, I would like to make reference to the bleak, medium-term balance of payments projections which are currently indicated for the Jamaican economy through the remainder of the decade. The wider financing gaps which are forecast will require a continued and strengthened adjustment effort, to which my authorities are committed. However, closing these gaps will also require even larger amounts of concessional international assistance if the Jamaican adjustment effort is indeed to succeed.

In conclusion, I urge my colleagues of the Board to support the proposed decision, which will reinforce the Fund's long-standing commitment to helping the economic adjustment efforts of my Jamaican authorities.

The staff had made a substantial effort to help the authorities modify the program in response to the difficulties that had arisen since the approval of the stand-by arrangement, Mr. Leonard said. The modifications preserved the aims of the original program and were consistent with the fairly tight political constraints in Jamaica.

The authorities attached importance to the requirement to stabilize the exchange rate to some degree at the present juncture while maintaining their basic flexible management of the rate, Mr. Leonard continued. They had concluded that, unless the exchange rate were stabilized to some extent, the achievement of the overall adjustment effort would be jeopardized. They recognized the difficult implications for economic management of an effort to stabilize the exchange rate, but they had shown their commitment to the agreed modifications through the actions that they had taken to achieve the indicative targets for the end of January 1986.

The authorities believed that the deep-rooted problems facing the economy might require medium-term structural adjustment as well as more balanced demand management, Mr. Leonard commented. The precise steps that were needed should become clear when the tripartite mission to which the staff and Mr. Massé had referred made its recommendations. Meanwhile, the Executive Board's approval of the proposed waiver and modifications and success in bringing the program back on track--something to which the authorities were clearly committed--would play a vital role in ensuring that any new policy approach that might be needed could be introduced against a reasonably favorable economic and social background.

Mr. Arias remarked that despite Jamaica's close association with the Fund over the previous decade, the re-establishment of a basis for resuming sound and stable noninflationary growth was proving difficult to achieve. The staff paper described the latest sharp deterioration in

Jamaica's balance of payments owing to exogenous factors that had complicated the task of economic adjustment in Jamaica, which was heavily indebted and clearly vulnerable to external shocks because of structural factors.

Jamaica's medium-term and long-term external debt was the equivalent of 180 percent of GDP while total debt servicing was equivalent to 60 percent of exports of goods and services and interest payments accounted for 35 percent of those exports, Mr. Arias noted. Since 1980, bauxite sector exports had been more than halved, from US$732 million to US$275 million, and foreign exchange earnings had declined correspondingly. As a result, despite the significant adjustment measures that had been implemented over the previous 12 months--including the 16 percent real effective depreciation of the Jamaican dollar, the major liberalization of imports, and the reduction in the central government deficit--the economic situation had deteriorated during 1985. Real GDP had recorded a cumulative decline of 4 percent over the previous two years, while the rate of inflation remained high, and approximately one quarter of the labor force was unemployed. Equally important, the adjustment process had resulted in extensive social disturbances. The adjustment of the external current account had been difficult because of the adverse external environment, but the nonobservance of a number of performance criteria had been inevitable, given the interrelationship among the net domestic and foreign assets of the Bank of Jamaica, the external arrears, and the restrictions on payments due to the accumulation of the arrears.

Given the difficult economic and financial situation, including the precarious external liquidity position, the authorities had correctly concluded that a comprehensive adjustment program involving a fundamental departure from existing policies was needed, Mr. Arias continued. To the Fund's credit, the institution had responded to Jamaica's need in a flexible manner by encouraging appropriate policy adjustments in the program in the light of the changing circumstances and unforeseen developments that had been beyond the control of the authorities. That response augured well for the future design of Fund-supported programs.

The adjustment effort in Jamaica was correctly focused on solving the fundamental budgetary problems as a part of the overall effort to implement appropriate demand management policies and needed structural reform, Mr. Arias remarked. The need to mobilize domestic financial resources could not be overemphasized, given the low gross savings rate of 8 percent of GDP and the unfavorable outlook for external financial assistance. The effort to strengthen control of the key components of public expenditure was appropriate. It included mainly a restrictive public sector wage policy underpinned by a reduction in the size of the public sector and an elimination of subsidies in a number of areas. On the revenue side, the fiscal program that had been implemented in January 1986 adopted measures designed to increase revenue by approximately 1 percent of GDP in January-March 1986. In addition, in line with the recommendation of the fiscal review study that had been undertaken in conjunction with U.S. AID, the authorities had implemented a major reform of the tax system to improve its efficiency and effectiveness. Individual income tax rates had been reduced, and the income tax base had been widened. Moreover, the authorities planned to reduce the corporate income tax rate in 1987 and to improve further the structure and to increase the elasticity of the tax system by converting the indirect taxes into a general consumption tax. The tariff structure was being rationalized in line with a study conducted by the World Bank.

Despite the tightening of fiscal policy and the adoption of a very restrictive monetary stance, the staff felt that considerable additional fiscal action was needed to close the large gaps that were expected in 1986-87 and beyond, Mr. Arias noted. Therefore, restrictive demand management policies to speed up the adjustment to lower levels of real income resulting from the deterioration in the terms of trade were inevitable. This process could only be affected by substantial costs in terms of lost output and increased unemployment as well as adverse effects on income distribution. Sustained implementation of adjustment measures was required, but that could be accomplished only within a growth-oriented strategy that received adequate financial support. This broad strategy had gained wide recognition within the international financial community, and the strategy was thought to be particularly hopeful in solving the debt problems facing many developing countries. The viability of Jamaica's external and domestic adjustment efforts would hinge crucially on the country's obtaining additional external concessional and nonconcessional financial resources and its negotiating a comprehensive debt restructuring so that its investment program could be maintained or enhanced. Increased investment could pave the way for the economic transformation and diversification of the Jamaican economy that was needed to achieve sustained growth. To those ends, a more favorable external environment would certainly be helpful. The proposed decisions were acceptable.

Mr. Suraisry said that the authorities' recent strong adjustment effort had considerably reduced the fiscal deficit. In addition, the exchange rate had been allowed to float freely, a major liberalization of imports had been undertaken, and substantial progress had been made toward eliminating the external payments arrears.

The authorities' various adjustment efforts were commendable, but developments in early 1985 showed that the already difficult economic situation had significantly worsened and the financing gaps had widened, Mr. Suraisry continued. In the circumstances, further strong adjustments were needed if the economy were to be brought back on track and Jamaica were to maintain the confidence and financial support of the international community.

Under the new adjustment program the authorities did not plan to use the exchange rate tool in the adjustment process, Mr. Suraisry noted. They preferred to concentrate the burden of adjustment on demand management policies. The policy mix that they had chosen might have significant costs in terms of output and employment, might protect consumption at the expense of investment, and, even more important, might weaken the process of export diversification and structural adjustment. Those possibilities were a cause for concern, particularly in view of the already high rate of unemployment and of the need for diversification and structural reform.

An excessively rapid depreciation of the Jamaican dollar might be a cause for concern, Mr. Suraisry remarked. However, pegging the nominal exchange rate in an environment of rapidly rising domestic prices was tantamount to a real appreciation that would require an overadjustment of other policy instruments. That possibility raised the question of how long the authorities could sustain an artificial real appreciation of the Jamaican dollar and the cost of such an effort. The opportunity cost to the economy of using scarce resources to maintain an artificial real appreciation of the Jamaican dollar might well prove to be substantial.

The authorities' apparent heavy reliance on demand management was a short-term solution to the problems facing the economy that would entail costs in the form of increased difficulty in attaining important long-term objectives, Mr. Suraisry commented. Therefore, the authorities might be well advised to maintain a flexible exchange rate policy that would be consistent with a gradual and orderly adjustment of the nominal exchange rate in line with the staff's recommendation. In that connection, the data presented on page 25 of SM/86/26 indicated that both the original program and the proposed revised program implied the same nominal and real growth rates and the same inflation rate, even though domestic liquidity growth was projected to slow from 17.5 percent to 4.8 percent and fiscal policy was to be tightened.

The authorities were to be commended on the progress that they had made in tackling the fiscal imbalance despite the sharp reductions in government revenue resulting from the deterioration in the bauxite sector, Mr. Suraisry said. The tax revenue measures that had been implemented in early 1986 were particularly welcome. However, the fact that those measures would not increase the elasticity of the tax system was a cause for concern. The authorities had recently announced a major reform in the income tax system, and the staff could have usefully provided a written assessment of the economic and revenue implications of that reform. The information would have helped Executive Directors to evaluate the effects of the reform on the adjustment program. The opening statement on the reform by the staff representative from the Western Hemisphere Department was welcome, especially the conclusion that the reform apparently was expected to be revenue neutral. If the reform proved to be harmful to the fiscal position, the authorities should be prepared to take additional, offsetting measures, as the financing gap was already substantial.

On the expenditure side, he agreed with the staff that a thorough review of expenditure priorities and of the controls on central government outlays was required, Mr. Suraisry continued. That review would clearly identify areas of potential expenditure retrenchment, thereby avoiding the possible adverse effects of ad hoc expenditure cuts.

For some time the authorities had make commendable progress in tightening liquidity conditions through their open market operations, Mr. Suraisry remarked. However, there had recently been significant slippages in that area, and the authorities' intention to return to the programmed monetary targets was welcome. However, it was important to keep in mind the effects on the private sector of the credit squeeze that had been required to achieve the balance of payments and inflation targets. Given the private sector's already limited access to credit, strict adherence to the limit on the borrowing requirement of the public sector was essential to prevent further crowding out of the private sector.

Jamaica's external position was still serious, Mr. Suraisry said. The growing external debt service requirement, the structural deterioration in traditional exports, and the weak performance of nontraditional exports had caused an increase in the already large financing gaps, and the medium-term balance of payments outlook suggested that large gaps were likely to persist through the end of the 1980s. Therefore, achieving a sustainable balance of payments position would continue to be a major challenge for some time. To meet that challenge the authorities should make a strong and sustained adjustment effort that would address structural and institutional problems as well as the need for appropriate demand management policies. The support of the international financial community would also be required. Finally, the proposed decisions were acceptable.

Mr. Rye recalled that during the previous discussion on Jamaica, his chair had noted the ad hoc nature of the authorities' economic programs and the lack of a consistent, credible, and--above all--long-term approach that would enable the authorities to make a serious effort to come to grips with Jamaica's massive economic problems. Unfortunately, those conclusions were applicable to a considerable extent to the revised program. Moreover, the Executive Board was being asked to endorse what was essentially an antigrowth strategy. It was ironic that, as the Fund was often accused of imposing antigrowth policies on reluctant members, the Jamaican Government seemed determined to implement such policies which the staff apparently had been reluctant to support.

The centerpiece of the authorities' present strategy was the pegging of the Jamaican dollar to a level--US$1.0 = J$5.5--that had been reached in April 1985, Mr. Rye observed. Accordingly, to bring the program back on track the authorities must impose substantially tighter fiscal and monetary policies. That approach clearly could not be sustained beyond the short term. The rate of inflation already exceeded 20 percent, and any pegged exchange rate--let alone a current rate that matched the rate that had been reached nearly 12 months previously--could not remain viable for long. It was stated on page 9 that the authorities believed that most sectors of the economy were internationally competitive when the exchange rate was at the J$5.5 level. In his statement on behalf of Mr. Massé, Mr. Leonard had referred to studies that had been undertaken in Jamaica that supported that conclusion, and Mr. Leonard had concluded that the 16 percent devaluation after April 1985 was "serious overshooting." He wondered whether the staff felt that the exchange rate level of J$5.5 was appropriate at the present stage.

Another reason for feeling that the authorities' present strategy would not prove tenable beyond the very short term was the burden that it imposed on the already stricken business sector by tightening fiscal and, especially, monetary policy, Mr. Rye remarked. The credit squeeze mentioned by the staff and the higher interest rates would adversely affect businesses and prolong and deepen the economic stagnation. Accordingly, he wondered why the authorities believed that their adjustment program would prevent an undermining of business confidence.

Even more important, the authorities' strategy did little to assist the needed process of structural reform, Mr. Rye commented. Private sector investment was likely to be inhibited, the development of nontraditional exports stifled, and the much-needed diversification of the economy further delayed.

The tax reform was welcome, Mr. Rye said. At first glance, the revisions of the income tax system seemed to be a worthwhile structural reform. However, further steps were needed to improve revenue collection. As the staff had noted, approximately half of the addition to revenue resulting from the tightening of the fiscal stance in 1985 would not be repeated in subsequent years and would therefore not help to close the large budget gaps expected in 1986/87 and beyond; that outlook underscored the ad hoc and short-term nature of the authorities' present strategy. He agreed with the staff that the authorities needed to pay close attention to public expenditure and that a comprehensive review of the priorities and controls relating to all central government outlays was urgently required.

The authorities' program had contained only a few of the medium-term measures that the Executive Board believed should receive greater priority in Fund-supported programs, Mr. Rye commented. That fact created a dilemma; indeed, he had considered withholding his support of the proposed decisions. However, he had finally concluded that the proposed decisions should be accepted for two reasons. The first had to do with the arguments that had been made by the Jamaican authorities in support of their adjustment strategy. The authorities apparently wished to forestall more social unrest of the kind that had occurred in January 1985 following the sharp increase in petroleum prices. When considering such political areas Executive Directors must in the end defer to the judgment of the authorities concerned, who were ultimately responsible to their own electorate. However, it was appropriate to raise certain questions. For example, he wondered what particular consequences were feared as a result of the floating of the exchange rate; petroleum prices were obviously not an issue in the present circumstances. He also wondered whether the authorities were not concerned about the possibility of civil unrest resulting from the higher unemployment that the Government's strategy would seem to entail, particularly since, as Mr. Masse had noted, there were already layoffs and redundancies spread across the economy.

The second, and more important, reason for reluctantly accepting the proposed decisions was that they were clearly intended to be only a stop-gap measure, Mr. Rye continued. He attached great importance to the supply-side review being conducted by the Fund, the World Bank, and U.S. AID, which was to be completed by the end of March 1986. Mr. Massé had given the Executive Directors his assurance that the Jamaican authorities themselves would attach great importance to the findings and recommendations resulting from the review in the belief that they would provide a good basis for strengthening and broadening the authorities' adjustment effort. Strengthening and broadening that effort were clearly required, if only to attract the continued high level of external support that was needed to close Jamaica's wide external gaps.

Jamaica was current in its obligations to the Fund, Mr. Rye noted. However, overdue obligations equivalent to SDR 70 million had accumulated by January 1986. Completion of the next review or the consideration of any alternative adjustment program should be conditional to no small degree upon Jamaica's willingness to live fully up to its obligations to the Fund between the present stage and the consideration of the review or program.

Mr. Grosche said that it was regrettable that after the fresh start that had been made under the previous stand-by arrangement, the effort to achieve the needed adjustment and growth had suffered a setback during the implementation of the present stand-by arrangement. The slippages were attributable partly to unfavorable developments that were beyond the control of the authorities, but they had been compounded by inadequate domestic policies in general and by the inappropriate mix of demand restraint and the level of the exchange rate in particular. The authorities understandably wished to limit the effects of exchange rate depreciation on domestic prices, but they might not have been fully aware of all the risks involved in supporting an artificially high exchange rate. The staff had noted those risks in its appraisal: a real appreciation of the Jamaican dollar weakened the process of export diversification and structural change, thereby negatively affecting growth. The Executive Board had repeatedly stressed the need to strengthen the process of structural adjustment in order to reduce the economy's heavy dependence on bauxite and alumina. The medium-term outlook for the economy confirmed the need for a timely, comprehensive, and sustained adjustment effort. He shared the staff's concern about the sustainability of the current monetary and fiscal policy mix, which was required to reconcile the goal of maintaining a given exchange rate with the goal of ensuring the achievement of the balance of payments objective under the adjustment program.

He recognized the efforts that the authorities had made to meet the indicative targets for the end of January 1986 and their firm commitment to meet the targets for the end of March 1986, Mr. Grosche said. Those efforts were commendable, as were the authorities' plans to implement a major tax reform in the near future. However, the negative effects of an additional tightening of demand management on investment, output, and employment were a cause for concern. Those effects could be moderated under a more flexible exchange rate policy. In addition, he was worried about the Fund's image: the Fund's support of Jamaica's adjustment program gave the impression that the Fund favored antigrowth policies, something that was untrue.

The proposed decisions would enable Jamaica to make drawings retroactively for periods in which performance criteria had not been observed, Mr. Grosche noted. The staff had made that proposal on the expectation that, by the end of March 1986, the program would be back on track, at least with respect to the observance of the revised performance criteria. Meanwhile, however, inappropriate policies would continue to hamper the appropriate evolution of Jamaica's economy.

He was willing to support the proposed decision--despite his serious concerns about the adequacy of the authorities' present policies--because of the clear indication that Mr. Leonard had given in his opening statement that the authorities were willing to take a fresh look at the situation on the basis of the findings of the tripartite commission, Mr. Grosche said. As he understood it, the Fund's relations with Jamaica would be in a transitional stage until March 1986, when the tripartite mission's report would be completed and discussions would be held to define the policies for the remainder of the program period. As he interpreted the staff's conclusions in its paper, no policy options would be excluded during those discussions. That approach was fully appropriate.

Mr. Dallara remarked that the case of Jamaica was a difficult one. The authorities had faced a particularly unfavorable external environment: there had been a sharp decline in bauxite exports as a result of both volume and price developments; tourism revenues had fallen far short of expectations, owing in part to domestic disturbances following price adjustments; and concessional aid inflows had been less than expected.

In his opening statement Mr. Leonard had noted that the unrest in January 1985 had been triggered by an increase in petroleum prices that had been linked to the previous adjustment program, Mr. Dallara continued. It was important to note that the price increases under the previous adjustment program had been necessary in light of earlier delayed price adjustments that the Fund had encouraged the authorities to make. That point was worth making in order to clarify the relationship between the 1985 adjustment program and the price changes that had indeed appeared to have had social effects.

The severity of the shortfalls in the various sectors of the economy was reflected in the balance of payments data, Mr. Dallara commented. It was difficult to envisage any package of economic policies that could result in a rapid turnaround in Jamaica's current economic situation. With that fact in mind, he was willing to go along with the authorities' present, temporary approach to dealing with the immediate problems facing the economy. However, the present combination of policies in Jamaica would not be sustainable over the medium term. The authorities should formulate a comprehensive, growth-oriented program that could lead to a positive and sustainable rate of economic growth along with a viable payments position in the medium term.

A positive development in recent months was the large increase in private capital inflows, which was an indication that confidence in the Jamaican economy had perhaps been restored, Mr. Dallara remarked. Those inflows were probably related in part to the restraint that had occasionally characterized Jamaica's monetary policy in 1985. However, to some extent that policy was a substitute for the adequate use of other policy instruments, including the exchange rate and pricing policies, and could therefore in the long run have detrimental effects on the prospects for growth by greatly increasing the cost of real investment. The authorities should broaden their policy response in order to permit some real increase in credit to the private sector.

The fiscal performance over the previous several years had been mixed, Mr. Dallara considered: the needed sharp reduction in the central government budget had been partially offset by the increasing losses of the Bank of Jamaica and the continued weak performance of the public enterprise sector. Additional revenue shortfalls had occurred earlier in 1986. The authorities had recently decided to tighten budgetary policy to complement the monetary restraint in an effort to support the exchange rate. Some aspects of the fiscal program were welcome, including the elimination of duplicated functions by the central and local governments, and the rationalization of the civil service, which would lead to a permanent improvement in the Government's position. However, the continued ad hoc approach to revenue measures was still a cause for concern.

The authorities had recently taken steps in the area of tax reform as a result of their consideration of the issues concerned over a number of years, Mr. Dallara went on. The tax reform program was an important factor in the effort to restore incentives to both local and foreign investors and was certainly commendable. He hoped that the Fund could actively support the implementation of the reform in the coming period. He had noted the staff's conclusion that the tax reform was likely to be revenue neutral.

The tax reform effort should be complemented by additional restraint on expenditures with a view to limiting further the role of the Government in the Jamaican economy, Mr. Dallara considered. That effort would require further permanent improvements in the performance of the public entities, including the Jamaican Trading Corporation, which was accumulating external arrears. That development might necessitate additional increases in prices of and fees for public goods and services. These increases were required in order to achieve a more rational pattern of utilization of domestic resources in support of economic growth. The longer such efforts were postponed, the more difficult and costly they would become.

The staff had encouraged the authorities to set priorities for central government outlays as a means of responding in an efficient and rational manner to the difficult medium-term fiscal outlook, Mr. Dallara commented. However, the staff's statement that full details were not available on the composition of current expenditure was worrying. Perhaps there was a lag in the availability of information and the problem was therefore temporary. If that was not the case, the authorities should work with the staff to ensure that the Fund would have the best possible information on such important areas as current expenditure. Given the long and close relationship between Jamaica and the Fund, and the number of Fund-supported programs in Jamaica, the data problems could and should be minimized; the authorities should do everything possible to achieve that objective.

He understood some of the reasons why the authorities did not wish to move the exchange rate, Mr. Dallara remarked. However, the rate of inflation was rather high, and the continued evidence of a large imbalance between the supply of and demand for foreign exchange seemed to call for a change in the price of foreign exchange. The authorities had chosen to reduce the fiscal imbalance in the short run by a combination of rather austere fiscal and monetary policies rather than permit adjustments in prices. That approach might be acceptable in the short run, but he shared the staff's concern that it would clearly entail costs to the economy in terms of employment and output in the medium term and that market forces must be permitted to play a stronger role.

The discouraging performance of nontraditional exports had been a factor in the widening of the medium-term balance of payments gap, Mr. Dallara commented. That development could be the result partly of exogenous factors, but there was a need for clear and early action with respect to exchange rate policy to enhance the prospects for nontraditional exports.

Given recent developments in the world economy, the decline in Jamaica's bauxite sector seemed to be irreversible, Mr. Dallara said. Steps should be taken in addition to an adjustment of the exchange rate to encourage the development of other sectors of the economy if the employment and growth goals of the Jamaican authorities and people were to be achieved. Those goals were not likely to be reached through the sustained implementation of the present policy mix. While it might be true that the exchange rate could be forced to its equilibrium level by a constriction of domestic demand, that approach clearly entailed high costs to the real economy--especially the private sector--and certainly was not advisable over the medium term.

An encouraging development with respect to the medium-term prospects was the consideration that was being given by the World Bank to sector loans to Jamaica, including loans for the financial sector, Mr. Dallara remarked. In the light of the unfavorable medium-term scenario, the additional World Bank assistance would be most welcome.

He was not aware of the full details of the findings of the tripartite commission, Mr. Dallara said. However, he hoped that the coordinated approach involving the Fund, the World Bank, and U.S. AID--Jamaica's largest bilateral donor--could support the effort to make needed policy changes in Jamaica.

He was willing to support the modified program, Mr. Dallara commented. However, the policies in that program should not be permitted to become entrenched; that outcome would involve excessive costs for the real economy. It was important to remember that Jamaica was a prolonged user of Fund resources, and that the medium-term prospects for the economy were particularly difficult, partly because of the external debt situation. Jamaica could not afford to add Fund-related debt to its present outstanding debts without introducing the kind of comprehensive economic program that would place the country in a position not only to restore sustainable growth and a viable payments position but also to meet its external obligations, including those to the Fund. The report of the tripartite mission was to be completed soon, and the authorities should accept its findings and move quickly to formulate and implement a comprehensive economic program that would attract the Fund's strong support and would improve the medium-term prospects for growth and a viable payments position.

Mr. Foot remarked that Jamaica had experienced considerable difficulties in recent years, owing partly to the sharp decline in its traditional industries and to factors beyond the authorities' control. However, there had also been errors in policy formulation, and it was particularly regrettable that the stand-by arrangement had been moved significantly off track during the second half of 1985. It was also regrettable that Jamaica's arrears to the Fund, which had occurred frequently, although briefly, had at one point risen to nearly SDR 70 million. He was pleased that the arrears had been eliminated and that there was considerable discussion in Jamaica on how the country should proceed in the coming period. An important contribution to that discussion was being made by the tripartite mission.

As he understood it, the original adjustment program had provided for a decline in the exchange rate against the U.S. dollar to J$6.9, Mr. Foot said. The authorities had recently decided to maintain an exchange rate against the dollar of J$5.5 and to adopt tighter fiscal and monetary policies to support that objective. As a number of Executive Directors had argued during the recent discussion on the design of Fund-supported programs, each government had the right to chose its own policies. However, as he had noted during that discussion, the Fund was entitled to assess whether those choices affected the likelihood that the Fund would be repaid, conformed with the Articles, and would adversely affect the Fund's image.

While an exchange rate adjustment might be appropriate, it could be argued that maintaining the current exchange rate in the short term would not further worsen Jamaica's future ability to repay the Fund, Mr. Foot continued. However, the consistency of Jamaica's program with the Articles and the effect of the program on the Fund's image were a cause for considerable concern. It was true that whatever adjustment measures were adopted at the present stage GDP was likely to fall in the short run. The main issue was whether the proposed program was likely to establish the basis for renewed growth in the longer run, as was implicitly required by Article I; in that connection, the staff paper was not reassuring. Indeed, he agreed with previous speakers that there was a danger that the Fund's association with the authorities' policies--which could easily be misrepresented as a requirement by the Fund that such policies should be introduced--would considerably harm the Fund's relations both with the Jamaican Government in the future and with other governments at present.

The staff paper was not reassuring because it provided no evidence that a case could be made for maintaining over time the current dollar exchange rate of J$5.5, Mr. Foot went on. The original program had envisaged a depreciation of the rate to J$6.9, and there had been no unexpected slowdown in the rate of inflation in Jamaica to warrant an exchange rate of J$5.5. Both the original and revised adjustment program envisaged a rate of increase in the consumer price index of 15 percent in 1985-86. By using reserves and, more recently, by the apparent sharp short-run tightening of fiscal and monetary policy, together with the onset of the tourist season, Jamaica had been able to push back and then hold the exchange rate at J$5.5. The immediate question that naturally arose was whether that rate could be maintained. He wondered whether intervention by the Bank of Jamaica to support that rate had been needed thus far in 1986 and whether the ending of the tourist season in April 1986 would undermine the authorities' present exchange rate strategy. Another question that naturally arose was whether the current mix of policies could be justified beyond the coming several months, and, in particular, why the staff believed that a dollar rate of J$5.5 seemed viable; after all, the staff had originally projected a rate of J$6.9.

In his opening statement Mr. Leonard had given political, social, and economic reasons for the authorities' supporting the present exchange rate, Mr. Foot remarked. He wondered whether the sharp fall in the price of oil was likely to give the authorities any more room in which to maneuver to reduce the exchange rate. Mr. Hodgson had noted that studies undertaken in Jamaica indicated that an exchange rate of J$5.5 supported export competitiveness. A further comment on the findings of those studies would be helpful. The only one of which he was aware was a draft produced by a consultant working for the World Bank which used a technique called domestic resource costing to establish which industries appeared to be internationally competitive. That methodology was interesting but controversial, and the study concerned apparently did not support a particular exchange rate as being the appropriate rate.

There was little in the staff paper to suggest that the present exchange rate supported competitiveness, Mr. Foot went on. Table 6 showed that exports other than bauxite and alumina had totaled US$245 million in 1983/84, US$287 million in 1984/85, and only US$255 million in 1985/86, compared with the initial program estimate of US$306 million. That actual decline in nonbauxite exports, together with the expectation of continued domestic inflation in excess of 10 percent in 1986/87 as shown in Table 3, did not support the substantial projected increase in exports other than bauxite and alumina shown in Table 7. For example, nontraditional exports were forecast to rise from US$160 million to US$281 million between 1985/86 and 1989/90. He wondered what exchange rate those projections were based on. For example, they could be based on the J$7 to the U.S dollar exchange rate in 1986/87 that was identified in Table 3 as the nominal exchange rate that was needed to maintain the real exchange rate constant at the 1978 level. He strongly agreed with previous speakers that the exchange rate issue should be explored intensively during the coming period. His chair would be looking with great interest at that area during the next review under the stand-by arrangement.

The proposed tax changes contained desirable structural elements, and the staff had described them as being significant, Mr. Foot noted. The staff could have usefully circulated a description of the new measures prior to the present meeting. The Prime Minister had described the tax measures as including the largest single program of personal income tax reform in Jamaica's history. Hence, even if the new measures were revenue neutral, they were clearly significant. He did not have sufficient information to judge whether the new measures were revenue neutral, and he wondered whether the staff had had an opportunity to take a view on the matter. It seemed likely that such major reforms would lead to dramatic changes in the behavior of taxpayers.

Table 2 showed that the performance criteria for September and December 1985 had been seriously breached; the relevant variables were nowhere near the indicative targets, which had been set at the end of January 1986, Mr. Foot continued. Table 2 showed that the indicative target for the net central government borrowing requirement for the end of January 1986 was J$142 million higher than had originally been programmed for the end of 1985. Nevertheless, the Executive Board was being asked, on the basis of the current review, to agree forthwith--rather than after an examination of the observance of the performance criteria for the end of March 1986--to permit Jamaica to make up all the previously lost drawings under the stand-by arrangement. The conclusion that could easily be drawn from that proposal was that a significant departure from the original program could result in a revision of the program that permitted a full catching up of all missed drawings before the country had been able to meet even the original goals under its program. That precedent was worrying, and, in the absence of exceptional circumstances, his chair would oppose any future programs which incorporated that feature.

He greatly sympathized with the authorities, as the situation in Jamaica was clearly a difficult one, Mr. Foot said. He hoped that the current discussions designed to take a fresh look at the difficult Jamaican case would be constructive and fruitful.

Mr. Coumbis commented that the economic situation of Jamaica continued to be serious. Despite the authorities' strong adjustment efforts, there had been slippages in the 1985/86 program, owing significantly to a number of external factors and to policy mistakes. By September 1985 it had been clear that the external current account deficit would increase to 16 percent of GDP, rather than the 11.5 percent noted in the program, because of a sharp drop in alumina prices, the merely moderate performance of nontraditional exports and tourism, and the higher than programmed volume of imports. In addition, shortfalls in official capital inflows had resulted in a further accumulation of arrears and a lower than planned increase in reserves.

Those developments had indicated that stricter adjustment policies were needed to bring the program back on track, Mr. Coumbis went on. However, the authorities had decided to change their overall adjustment strategy as well. Under the original program, it had been assumed that the Jamaican dollar would depreciate from J$5.5 per U.S. dollar at the beginning of the program period to aroud J$6.9 in March 1986. Under the new strategy, the Jamaican dollar would remain unchanged during the whole program period, and the authorities would intensify their fiscal and monetary policy adjustment efforts in order to reduce absorption. The authorities expected that, after two rounds of expenditure reductions of approximately 2 percent of GDP and a series of measures designed to raise revenue by 1 percent of GDP, the overall fiscal deficit of the Central Government would be reduced to 5.1 percent of GDP and that by the end of March 1986 that deficit would be J$100 million below the target level. In addition, the authorities planned to permit no increase in commercial bank credit to the private sector during 1986; to that end, they intended to sell large amounts of Treasury bills and certificates of deposits in order to drain the liquidity that had been accumulated by the commercial banks.

The authorities' new strategy was not promising, Mr. Coumbis said. He agreed with the staff that the pegging of the exchange rate would be feasible only temporarily. The authorities were convinced that a depreciation of the Jamaican dollar would result in price increases for gasoline and basic foods that, in turn, would cause civil disturbances. That argument was logical, but if the authorities continued to keep the exchange rate pegged at the March 1985 level for a long period while prices continued rising by 15-18 percent, the economy's competitiveness would be undermined, the outflow of capital would accelerate, and monetary and fiscal policy would have to be strongly adjusted in order to reduce absorption. However, those policies might result in a significant increase in interest rates and in unfavorable results with respect to investment, economic activity, and employment. Accordingly, the authorities should re-examine their policies as soon as possible.

During the previous discussion on Jamaica, his chair had noted that the balance of payments projections indicated large financing gaps through the end of the projection period, Mr. Coumbis recalled. In his summing up of that discussion the Chairman had stressed that in light of the very difficult medium-term outlook, a sustained and vigorous adjustment effort would have to be implemented with resolution, there was no room for slippage, and the authorities' efforts would have to be supported by large-scale, concessional external assistance and by debt rescheduling. In its present paper the staff had indicated that the medium-term financing gaps had widened because nontraditional exports were stagnating and tourist receipts had fallen. The staff had also indicated that if those gaps were to be closed, imports should be reduced substantially, and further exceptional balance of payments assistance as well as continued debt rescheduling would be required. The situation of Jamaica was so difficult that the usual policy presciptions would not prove sufficient; assistance under the Special Disbursement Account might be required. In that connection, the present review of Jamaica's medium-term strategy by the tripartite mission was a step in the right direction. He shared the authorities' hope that that mission would provide a good basis for strengthening the Government's adjustment effort on a more consistent basis. In the light of the authorities' commitment to their adjustment effort and of the political and social problems facing the country, the proposed decisions were acceptable.

Mr. Ortiz recalled that during the discussion on Chile's extended arrangement (EBM/86/39, 2/28/86), his chair had noted that although Chile had observed the performance criteria, the country's ability to service its foreign debt had been reduced. Despite the remarkable adjustment capacity that had been shown by the economy, adverse external developments had kept Chile from improving its medium-term debt situation.

Jamaica's situation was much more complicated, Mr. Ortiz continued. Jamaica had suffered a series of severe external shocks and had a long history of unsuccessful stabilization attempts. During previous discussions on Jamaica, his chair had noted that the country's debt position, outstanding use of Fund resources, and medium-term economic outlook raised several questions concerning Jamaica's basic solvency and the nature of the Fund's involvement in the country. In particular, his chair had expressed serious doubts about the feasibility of designing a Fund-supported program that would re-establish a sustainable balance of payments position and permit Jamaica to service its commercial debt despite the rescheduling of the principal.

Developments in recent months had reinforced those views, Mr. Ortiz went on. The debt/GDP ratio of more than 200 percent was the highest in the Western Hemisphere, was one of the highest in the world, and was projected to increase an additional 20 percentage points toward the end of the 1980s. Those figures did not reflect the large financing gaps projected for the medium term. The debt/export ratio was more than 700 percent, and interest payments were the equivalent of nearly 60 percent of exports. There had been a substantial revision of the projections contained in EBS/85/162, which also contained Jamaica's request for the present stand-by arrangement. The widening of the financing gaps since the previous medium-term projections was due to the bleaker prospects for alumina exports and the disappointing performance of nontraditional exports and tourism. For example, the current account deficit as a proportion of GDP had been expected to decrease from 11.6 percent in 1985/86 to 1.8 percent in 1989/90; at present, however, it was expected to reach 16.2 percent of GDP in 1985/86 and to fall to about 13 percent in 1989/90.

Given the very difficult situation at the beginning of the program period and the recent developments that the staff had described, he hoped that the recommendations of the tripartite mission that was reviewing the authorities' medium-term strategy would address the fundamental issues concerning the viability of the Jamaican economy, Mr. Ortiz commented. It was clear that a solution to Jamaica's debt problem--which would probably have to include partial cancellation of outstanding obligations or larger amounts of concessional international assistance--must be an essential part of any program that was designed to re-establish conditions for sustained economic growth in Jamaica. Stabilization policies aimed at correcting macroeconomic imbalances and structural adjustment programs aimed at reducing the role of the public sector, stimulating private sector activity, and improving economic efficiency in general could not succeed if basic problems concerning Jamaica's economic viability and financial solvency went on untackled.

The authorities had noted that the disappointing balance of payments performance in the first nine months of 1985/86 had occurred mainly because of the larger than expected decline in bauxite and alumina exports, Mr. Ortiz remarked. Tourist receipts--which had also been lower than expected--had been hurt mainly by the negative repercussions of the civil disturbances that had occurred in early 1985 and 1986. However, the authorities believed that the sluggish behavior of nontraditional exports was due more to a lack of business confidence than to insufficient stimulus from the exchange rate. The authorities had also noted that a rapid depreciation of the exchange rate could further undermine confidence because of the impact on prices of consumption items purchased by lower-income groups and the disturbances that those increases could trigger. The authorities had decided to implement policies designed to reduce the pace of exchange rate depreciation. They intended to offset the adverse effects of that effort on the balance of payments by maintaining a more restrictive domestic policy stance.

The authorities' position was understandable, as the confidence problem that they had noted must be closely related to the broader issues of economic viability and solvency that he had mentioned, Mr. Ortiz continued. However, he agreed with the staff that the proposed exchange rate policy could be effective only in the short run; a real appreciation was clearly not the appropriate response to Jamaica's balance of payments situation. If the authorities believed that containing the depreciation of the exchange rate while further tightening domestic demand management policies was the most effective means of preventing a deterioration in social conditions until a more definitive medium-term plan could be adopted, he would have no difficulty in endorsing the proposed decision. In that connection, it was useful to bear in mind that the tripartite mission expected to complete its report toward the end of March 1986, so that policy understandings for the remainder of 1986 could be formulated in the context of the mission's proposals.

He shared the staff's concern about the additional contractionary effect of the measures that the authorities intended to implement, Mr. Ortiz said. A less restrictive stance on credit to the private sector would have been preferable, even if it would have implied a revision of the balance of payments targets for 1985/86. In the circumstances, attaining the precise quantitative performance criteria for the current fiscal year seemed less important than establishing an adequate foundation for launching a strategy aimed to solve Jamaica's more basic problems.

Mr. Wijnholds commented that the situation in Jamaica seemed to have continued to deteriorate, owing partly to external developments that had hit Jamaica hard, and partly to actions of the authorities. For example, he wondered why the authorities had thought that it was necessary to permit imports to rise more strongly than had been envisaged under the program, why they had relaxed monetary policy, and why relatively large amounts had been spent on intervention in the foreign exchange market. In his opening statement Mr. Leonard had given various explanations for Jamaica's predicament and for the authorities' policy actions, including the authorities' decision to engineer an appreciation of the Jamaican dollar. The political factors involved could best be judged by the authorities themselves, but it was imperative for the Fund to point out to the authorities what the economic consequences of their actions were likely to be, including the chances of incurring arrears, something that the Fund could not accept.

The causes of the problems facing the economy were well known and had been discussed at length on previous occasions, Mr. Wijnholds recalled. Given the revised medium-term scenario, he agreed with Mr. Leonard that the outlook for the economy was bleak. Presumably the relatively large increases projected for nonbauxite exports and travel were based on the assumption that the authorities would maintain the flexible exchange rate policy that the staff had strongly advocated. The authorities' reluctance to permit the exchange rate to fall too quickly in view of the significant effects on prices in Jamaica's open economy was understandable, but he wondered why the authorities would wish to maintain the exchange rate at a level that probably deviated substantially from the level that would be set by market forces. The staff had correctly noted the considerable costs involved in maintaining such a policy.

Two aspects of fiscal policy were a cause for concern, Mr. Wijnholds remarked. First, the tightening of fiscal policy was based excessively on one-time-only measures and was therefore unlikely to be sustainable. Second, the imminent tax reform, in which U.S. AID apparently had had an important input, raised some questions. The staff paper gave the impression that the reform would, at least in its early stages, not be revenue neutral. However, in his opening statement the staff representative from the Western Hemisphere Department had mentioned that the tax reform was intended to be revenue neutral. He hoped that the tax reform would prove to be revenue neutral, as Jamaica could ill afford a widening of the fiscal deficit in present circumstances.

He could go along--albeit reluctantly--with the proposed program waivers and modifications, Mr. Wijnholds said. The Fund faced a difficult problem in Jamaica and was treating the country very flexibly. That approach was acceptable because of the involvement of the tripartite mission, which was about to report on Jamaica's medium-term outlook and policy choices. He hoped that the authorities would be prepared, like the tripartite mission, to take a fresh look at the situation in Jamaica.

The staff representative from the Western Hemisphere Department remarked that the staff believed that the present short-term policy mix could have harmful effects on long-term structural adjustment in Jamaica. Accordingly, the staff had gone to considerable lengths to discourage the authorities from maintaining the present policy mix.

The latest information available to the staff had not warranted a significant change in the figures for nominal and real GDP in the revised program, the staff representative explained. The policy modifications had been made when the current fiscal year was already nine months old; accordingly, the new policies would be in effect for only about three months of that year and would not materially change the level of nominal and real GDP. Although the new policies might result in a lower rate of inflation than had originally been expected, the average increase in prices for the whole year would probably be higher than had been originally predicted. The average increase in the consumer price index in April-December 1985 was about 25 percent, and the average rate for the program year as a whole had originally been projected at 23 percent.

The substantial private capital inflows were difficult to explain, the staff representative commented. There had been many factors behind those inflows, which were reflected in the "errors and omissions" item in the balance of payment. The financing of the bauxite sector, and particularly the recently opened plant leased by the Government, had in some cases been based on future deliveries of bauxite; accordingly, imports had entered the country without corresponding payments, a development that might partly explain the so-called private capital inflows. In addition, the rules on access to the exchange market auction had been changed: importers previously had been able in effect to prepay for imports, but under the new arrangements they could gain access to the auction only through landed imports. That arrangement, which forced some input financing, might show up as capital inflows, but it would not necessarily reflect the re-establishment of confidence. The tight credit policies in April-September 1985 probably had also induced capital inflows. The deviations from the program targets in September and December 1985 indicated that private capital inflows had weakened and that tighter credit policies were called for.

The study on the exchange rate that had been financed by the World Bank, which Mr. Foot had mentioned, was based on a methodology that merely made sector-by-sector cost structure comparisons and did not take a global view on the adequacy of the exchange rate, the staff representative explained. A number of factors in addition to the cost structure of enterprises must be taken into account in judging the adequacy of the exchange rate. Those factors included the recent disappointing performance of nontraditional exports and tourism. In addition, it was important to remember that the exchange rate played a role in equilibrating the supply of and demand for foreign exchange; in recent months, the demand for foreign exchange for imports had been greater than had been programmed. At the same time, the recent fall in oil prices--which had occurred since the negotiations between the staff and the authorities that were reported in EBS/86/26--could be expected to ease Jamaica's payments position over the medium term. The recent appreciation of the U.S. dollar also should tend to help Jamaica. The staff still believed that the dollar rate of J$5.5 was not viable in the medium term and it looked forward to examining the recommendations of the tripartite mission.

The medium-term balance of payments projections presented in the staff paper included a fairly optimistic projection for the growth of nontraditional exports and tourism, and assumed no change in the real effective exchange rate that implied a persistent devaluation of the nominal exchange rate over the five-year period of the projections, the staff representative said. The projections implicitly included the assumption that the mix of policies would encourage rapid growth in nontraditional exports. Such policies would have to be in place under the next program if the projections were to prove to be accurate.

The domestic price consequences of any depreciation had been moderated by the recent fall in petroleum prices, the staff representative commented. At the time of the change in the authorities' policy stance, in October 1985, oil prices had not yet fallen and the exchange rate had reached a level at which gasoline prices would have had to be adjusted. Given the history of gasoline price adjustments in Jamaica and the fact that the high tourist season was about to begin, the authorities had felt very uncomfortable about the domestic price consequences of an exchange depreciation than they were at the present stage, following the oil price decline. Basic foods were also an important component of imports and the consumer price index, and the authorities worried about the effect of a change in the exchange rate on basic food prices.

Some Directors had wondered what had been the cost of intervention to stabilize the exchange rate, the staff representative remarked. The foreign exchange auction market in Jamaica was unusual, in that it covered only about one third of total transactions. Two thirds of the foreign exchange transactions handled by the central bank were not subject to the auction mechanism. The adequacy of the exchange rate should be judged in the light of the behavior of the overall balance of payments and the net foreign asset targets. The initial cost of intervention to reduce the exchange rate in October 1985 had been about US$40 million, but the deviation from the program targets in December 1985 could be considered as the true measure of the cost of the exchange rate policy. After adjusting for a temporary shortfall in bilateral aid flows, the program targets had been missed by about US$60 million. The program deviations would have to be made up in the first quarter of 1986 through the tightening of demand management policies--including an extremely tight credit policy.

The staff had great difficulty with Jamaica's fiscal data despite the Fund's long and close working relationship with the country, the staff representative commented. Detailed expenditure data were not available in a satisfactory manner except with a long delay, and the Government had not audited its accounts for many years. The staff measured the fiscal deficit from the financing side. Expenditure data were aggregated and did not permit an adequate analysis of the level of expenditure in various categories. It was for that reason that the staff had reiterated its call for a comprehensive study of government expenditure. Such a study could provide more disaggregated data which would help the authorities in their effort to tackle the fiscal deficit over the medium term.

The tax reform was clearly a major step, the staff representative said. The staff had not yet received detailed information on the tax reform but had been in touch with the consultants involved in the tax study and had been assured that the reform was intended to be revenue neutral. The staff would have to consider the tax proposals in detail before it could firmly conclude that they were likely to be revenue neutral.

It had been implied by Mr. Foot that permitting Jamaica to make two drawings on the basis of the end-January 1986 performance criteria, rather than the end-March 1986 criteria, implied that there might be some easing of the trajectory of the program, the staff representative from the Western Hemisphere Department remarked. The targets for January had been formulated with the intention of bringing the program back on track. It was difficult to formulate a program for a short period, especially on the fiscal side. The intention was to make the Janaury targets consistent with the desired March outturn; accordingly, no easing of the program had been planned.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. Foot had said that he was concerned that permitting Jamaica to make the two missed purchases upon the completion of the present review would establish a precedent and that he would prefer to wait until Jamaica observed the end-March 1986 performance criteria before permitting Jamaica to make up the missed purchases. It was not unusual for a member that had failed to observe performance criteria to be permitted to make a purchase upon the completion of a review. It was assumed that the review would include a package of policies that would enable the authorities to achieve the program objectives. The purchase of two missed purchases following a review was unusual but not without precedent. There were two other cases in the previous six months in which the completion of a review had enabled the member concerned to make two missed purchases.

Mr. Foot said that he would wish to examine the two cases that the staff representative had mentioned on a bilateral basis. He continued to be firmly opposed to the practice of permitting purchases to be made up in the way Jamaica was being permitted to proceed.

Mr. Leonard remarked that the authorities remained committed to a flexible exchange rate policy. An exchange rate level of J$6.2 per U.S. dollar had been envisaged under the original program but had not been a requirement under that program. The authorities had subsequently decided that a lower rate was advisable at the present stage for the reasons that were mentioned in the staff paper and in his own opening statement. The authorities believed that the present exchange rate would not hurt investment in the short run. Demand by the private sector for accommodation from the banking system had not been great with the exchange rate standing at its present level. One of the main problems at present was high interest rates, rather than the availability of credit. There was a danger that if the exchange rate were to increase and if prices were to rise in consequence, interest rates would have to be raised above their already high current level. It was true that a higher exchange rate would help to contain imports. However, it was important to remember that the relatively large volume of imports over the previous year had been due to certain lumpy items of capital investment. It was also true that the oil price decline gave the authorities some room in which to maneuver, and it was his understanding that they intended to take advantage of that situation by maintaining price levels while improving the fiscal position.

Executive Directors seemed to share the authorities' feeling that relations between Jamaica and the Fund were at a watershed, Mr. Leonard commented. On the authorities' side, that feeling was reflected in their determination to take a fresh look at the fundamental economic and financial situation through the tripartite mission. He was confident that the authorities were prepared to consider carefully the tripartite mission's recommendations, including a possible change in the exchange rate. The authorities' flexibility was evident in their policy commitments, and they routinely acted in as flexible a manner as possible. He would convey to the Jamaican authorities the reservations that Executive Directors had expressed during the discussion.

The Chairman said that he had noted the uneasiness evident in a number of Executive Directors' interventions. The proposed decision on the review under the stand-by arrangement was felt by staff and management to be the right course to take. He had held a number of discussions with the Prime Minister over the previous several months, and it had appeared to management that, in the present circumstances, it would have been disruptive to permit Jamaica's program to go off track without any effort by the Fund to show flexibility in response to the fresh look that the authorities were taking at the economy. Management and staff had carefully weighed the advantages and disadvantages of permitting the program to go off track and had concluded that it was best to propose to the Executive Board what might be considered a holding operation that would enable the Jamaican authorities, the World Bank, the donor community, and the Fund, acting within the framework of the tripartite mission, to look at the fundamental aspects of achieving medium-term growth in Jamaica. He hoped that the authorities would pay close attention to the view of the staff and the Executive Board on the kind of economic policies that would help to ensure medium-term economic growth in Jamaica. The authorities should clearly understand that one of the conditions for a successful medium-term growth strategy was a flexible exchange rate and exchange system. The authorities had shown considerable courage and determination in strengthening fiscal and monetary policy in order to adhere to the stand-by arrangement in the face of the very difficult political and other domestic conditions. The authorities clearly wished to maintain the adjustment momentum and to continue to work in a cooperative fashion with the Fund. Their willingness to do so had an important weight in the Fund's attitude toward the proposed policies.

The Executive Board then took the following decisions:

Stand-By Arrangement - Review and Modification

1. Jamaica has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Jamaica (EBS/85/162, Sup. 2) in order to reach understandings on the circumstances in which purchases can be resumed under the arrangement.

2. The letter from the Prime Minister and Minister of Finance and Planning and the Governor of the Bank of Jamaica dated January 31, 1986, the Amendment to the Technical Memorandum of Understanding attached to the letter of June 7, 1985 and the Understanding on Targets for January 31, 1986 shall be annexed to the stand-by arrangement for Jamaica and the letter of June 7, 1985 and the Technical Memorandum of Understanding attached thereto shall be read as modified and supplemented by these documents.

3. Accordingly, the quantitative limits and target of the stand-by arrangement through March 31, 1986 shall be as follows:

(i) the limit on the central government borrowing requirement referred to in paragraph 4(a)(i) of the arrangement shall be as stated in paragraph 2 of the Amendment to the Technical Memorandum of Understanding attached to the letter of June 7, 1985;

(ii) the limit on net domestic credit to the selected public entities referred to in paragraph 4(a)(ii) of the arrangement shall be as stated in paragraph 3 of the Amendment to the Technical Memorandum of Understanding attached to the letter of June 7, 1985;

(iii) the limit on net domestic assets of the Bank of Jamaica referred to in paragraph 4(a)(iii) of the arrangement shall be as stated in paragraph 4 of the Amendment to the Technical Memorandum of Understanding attached to the letter of June 7, 1985;

(iv) the limit on external payments arrears referred to in paragraph 4(b) of the arrangement shall be as stated in paragraph 7 of the Amendment to the Technical Memorandum of Understanding attached to the letter of June 7, 1985;

(v) the limit on net disbursements of new public and publicly guaranteed foreign indebtedness referred to in paragraph 4(d) of the arrangement shall be as stated in paragraph 5 of the Amendment to the Technical Memorandum of Understanding attached to the letter of June 7, 1985;

(vi) the limit on external public debt rescheduling or refinancing referred to in paragraph 4(e) of the arrangement shall be as stated in paragraph 6 of the Amendment to the Technical Memorandum of Understanding attached to the letter of June 7, 1985.

4. The Fund finds that the review contemplated in paragraph 4 of the stand-by arrangement has been completed, and that Jamaica may proceed to make purchases under the arrangement.

Decision No. 8210-(86/40) adopted
March 3, 1986

Exchange System

Jamaica retains a multiple currency practice resulting from the auction system as described in EBS/85/162. The Fund grants approval for the retention of this practice until May 31, 1986 or the completion of the next Article IV consultation, whichever is earlier.

Decision No. 8211-(86/40) adopted
March 3, 1986

3. WESTERN SAMOA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Western Samoa (SM/86/25, 2/10/86; and Sup. 1, 2/27/86). They also had before them a report on recent economic developments in Western Samoa (SM/86/29, 2/18/86).

Mr. Rye made the following statement:

Western Samoa is a typical small island economy in its heavy reliance upon a narrow range of volatile exports, as well as external financial and technical assistance. In addition, the economy is, to an unusual degree, sustained by remittances from abroad. It goes without saying, therefore, that Western Samoa's prospects are greatly influenced by external factors, although, as my authorities well recognize, external vulnerability also calls for prudent domestic policies.

My authorities broadly agree with the staff analysis, although, in a few particular respects, they are not as pessimistic as the staff seem to be. Notwithstanding a sharp deterioration in the terms of trade, economic performance in 1985 was relatively good. The current account deficit was contained to about the same as in 1984, external debt was reduced, inflation fell to 6 percent by year end, and real growth at a rate approaching 3 percent was achieved.

As the staff indicate, 1986 may prove to be a more difficult year, but the authorities have already largely put in place the requisite policy framework. The new Government, which took over in December 1985, plans to maintain a fiscal stance at least as prudent as that which has been in place since mid-1985, and intends to continue to manage the exchange rate flexibly so as to maintain competitiveness and profitability in the traded goods sector.

The authorities acknowledge the need for firmer monetary conditions in 1986, and to this end are taking steps to extend the range of monetary instruments available. A liquid asset ratio for banks has already been put in place, and the development of a treasury bill market is being planned. Consistent with these moves, consideration is being given to allowing interest rates to be determined more by market forces.

In addition, steps are being taken to avoid a recurrence of the credit expansion associated with the financing of the Copra Board in 1985. It is clear, with hindsight, that the adjustment of the producer price of copra in 1985 to the changed world price was not soon enough and did not go far enough, and my authorities have decided to privatize the commercial operations previously undertaken by the Board and to transfer the remaining price stabilization and marketing functions to an Export Development Board. This reorganization is also expected to contribute to the efficiency of the copra industry--the mainstay of the economy at present--in the medium term.

In the light of these actual and prospective developments and against the background of a prudent fiscal policy, my authorities do not fully share the staff's apparent perception that inflation will tend to accelerate in 1986.

In 1985, some direct controls over imports were reintroduced on a temporary basis. Given the limited macroeconomic instruments available to economies like Western Samoa, especially in the monetary policy area, my authorities considered it necessary, and in present circumstances, prudent, to introduce temporary direct measures to stem excessive growth in imports. They acknowledge, however, that such measures do not represent a "first best" approach and, as already outlined, are working toward developing instruments that should lessen the need for direct measures.

As for the medium-term prospects, my authorities agree that a cautious approach to policy will be needed for some time ahead. They believe, however, that the staff's medium-term scenario for the balance of payments may be on the pessimistic side. For instance, the scenario embodies an assumption that the terms of trade, which fell by 28 percent in 1985 and are projected to fall by a further 6 percent this year, will thereafter remain unchanged through 1990. Additionally, the scenario may make insufficient allowance for an expected increase in tourism receipts. With the major extension to the international airport now completed, there is the potential for tourism to grow rapidly, in which regard early indicators have been encouraging. It should also be noted that it remains the policy of my authorities as far as possible to restrict external borrowing to that which can be arranged on concessional terms.

In sum, my authorities believe that the policy framework currently in place should be broadly adequate to the challenge that Western Samoa expects to face in the short term. While, as always, there remains room for improvement in some areas and a need to be responsive to emerging developments, my authorities believe that they have already undertaken, or have in hand, the necessary efforts to restore financial restraint (see SM/86/25, page 17). As to the medium term, my authorities agree that they need to continue to build on the structural reforms and developments implemented in recent years.

> To conclude, my authorities would wish me to thank the staff for the most helpful reports that they have prepared for this consultation and, more generally, for the most valuable contribution that they have made to the development of economic policy in Western Samoa.

In the penultimate paragraph of his opening statement he had referred to the staff's conclusion on page 17 that efforts to restore financial restraint would have to be intensified, Mr. Rye went on. Apparently that conclusion was not meant by the staff to be an expression of its dissatisfaction with the new Government's budget. Nevertheless, the Government did not agree with the staff's conclusion concerning the appropriate degree of financial restraint in Western Samoa. At the same time, he would not wish to give the impression that there was any significant difference of views between the authorities and the staff. In that connection, the matters to which he had referred in his opening statement had to do merely with nuances of judgment. His authorities had no illusions about the very difficult external environment that Western Samoa faced and the need to maintain firm economic policies.

Mr. King said that 1985 seemed to have been a relatively successful year for Western Samoa, particularly given the sharp deterioration in the terms of trade. A performance characterized by growth of 2 1/2 percent, a decline in the rate of inflation, a narrowing of the budget deficit, and a fall in the debt/GDP ratio could not be called unfavorable.

Those favorable results were due partly to the more prudent policies that the authorities had followed over the previous several years with the support of stand-by arrangements in 1983 and 1984, Mr. King continued. Nevertheless, there were still areas that would have to be carefully monitored in the short and medium run. Both fiscal and monetary policies had been eased during part or all of 1985. The measures that had been introduced to tighten fiscal policy in the second half of 1985--especially the reduction in government borrowing from the domestic banking system--were particularly appropriate. It would be important for the authorities to maintain a cautious fiscal policy in 1986 if undesirable pressure on the external position were to be avoided. In that connection, the tighter policy stance that was projected in the 1986 budget seemed to be a step in the right direction.

Monetary policy had clearly been excessively loose in 1985, Mr. King commented. The effects of that relaxation were likely to create continuing difficulties for economic management through at least early 1986. The relaxation had stemmed partly from the strong expansion of credit to the public enterprises, especially the Copra Board. While the authorities' wish to provide adequate incentives for domestic copra producers was understandable, maintaining producer prices above the Copra Board sale price was undesirable beyond the short run, and the authorities' intention to restructure the Copra Board's operations was welcome.

A more satisfactory monetary policy would also require the introduction of more flexible monetary instruments, Mr. King went on. The present reliance on moral suasion as the major policy instrument was clearly undesirable. He endorsed the authorities' intention to examine possible moves toward a more decentralized financial system, including the possible introduction of a treasury bill market or the greater use of minimum liquidity requirements. In addition, as the staff had suggested, a more active interest rate policy might have an important role to play.

The medium-term scenario underscored the need for cautious policies, Mr. King said. While that scenario was not implausible, the assumptions on which it was based seemed somewhat optimistic. Even so, the scenario did not project any rise in the level of reserves from their current fairly low level, and some intensification of the policy effort would be required if additional external borrowing was to be avoided. Tourism could clearly play a significant role in the effort to strengthen the medium-term balance of payments position, and additional comments in the staff report on the prospects for that sector and on the appropriateness of current policies in that area would have been useful.

The authorities were to be congratulated for the significant improvement in the economy over the previous several years, Mr. King commented. However, the medium-term outlook remained uncertain, and the authorities would have to maintain prudent policies and continue their efforts to promote export diversification. The proposed decision was acceptable.

Mr. Kobayashi remarked that comprehensive adjustment programs had been successfully implemented under the two recent successive stand-by arrangements. Positive economic growth had been restored, the rate of inflation had declined, and the fiscal and external deficits had been substantially reduced. While the economy had been helped by a significant improvement in the terms of trade in 1983/84, much of the credit for the favorable outcome should be given to the authorities. In particular, the substantial revenue-raising measures, the tight credit policy, and the active exchange rate policy seemed to have made a valuable contribution to reducing the serious macroeconomic imbalances that had been evident in the early 1980s.

In 1985, the performance with respect to output and inflation also had been generally favorable, despite the sharp deterioration in the terms of trade, Mr. Kobayashi continued. However, the continuation of the momentum of vigorous adjustment seemed to have been somewhat jeopardized in the first half of 1985, when there had been some fiscal overspending and heavy recourse to domestic bank financing. Because of the re-emergence of domestic demand pressure, the authorities had had to resort to direct import control measures--including a measure that had given rise to a multiple currency practice--immediately after the expiration of the latest stand-by arrangement. Those measures should be replaced soon by appropriate demand management policies.

The economy's production base remained very weak, although progress had been made in strengthening the agricultural sector and agro-based industries through the use of incentive schemes, Mr. Kobayashi remarked. The authorities faced the challenge of maintaining the needed reserve target level of two to three months of imports. Particular importance should be attached to that target, because export receipts were volatile and the debt service burden would remain relatively heavy, including payments owed to the Fund. In the circumstances, the best interest of the country in both the short and long run would be served by maintaining cautious financial policies together with measures to strengthen output.

The measures that the authorities had recently introduced to control domestic demand pressure were encouraging, Mr. Kobayashi considered. A cautious spending policy had been reinstated in the second half of 1985, the producer price of copra had been reduced with a view to checking credit expansion, and the exchange rate had been managed flexibly in recent months. He particularly welcomed the fact that the proposed budget for 1986 envisaged an overall surplus of 2.1 percent of GDP and continued expenditure restraint. A large repayment of domestic bank borrowing was to be made under the proposed budget; that move would greatly facilitate the needed tightening of monetary policy.

He agreed with the thrust of the staff appraisal, Mr. Kobayashi said. On the fiscal side, the authorities' emphasis on expenditure restraint to reduce the budget deficit was appropriate given the substantial revenue measures that had been introduced in 1983/84 and the relatively high ratio of taxes to GDP. Nevertheless, efforts should be maintained to mobilize additional budgetary resources, and the current review of the income tax system was welcome.

Commenting on monetary policy, Mr. Kobayashi said that the recent strong import demand seemed to be closely associated with the rapid expansion of credit in 1985, and he agreed with the staff that a substantial tightening of monetary policy was needed. Liquidity growth of about 10-12 percent in 1986, as suggested by the authorities, seemed to be appropriate. The lack of effective policy instruments to absorb excess liquidity created by the external surplus required serious attention. The recent introduction of liquid asset holding requirements was certainly a welcome step, and more active use of other instruments should be explored.

The recent depreciation of the tala in real effective terms was welcome, and he hoped that a flexible exchange rate would be preserved over the medium term, Mr. Kobayashi commented. The recent reduction in outstanding external debt was also welcome. Given the limited debt servicing capacity, the authorities should try to finance the bulk of the external borrowing requirement on concessional terms. They had appropriately decided to limit commercial borrowing primarily to the refinancing of commercial debt. Finally, the proposed decision was acceptable.

Ms. Lundsager remarked that developments in 1985 underscored Western Samoa's vulnerability to world economic trends. The largest impact of those trends had been felt in the coconut sector, owing to a significant decline in the world price of coconuts. Other developments had more than offset those trends, especially the sizable inflow of remittances, external grants, and tourist receipts, thereby permitting the overall payments position to remain in surplus, although to a smaller extent than in 1984.

The vulnerability of the economy was obviously apparent to the authorities, who were implementing policies aimed at strengthening the basic economic performance by managing overall demand in light of available resources and by encouraging a more resilient, diversified, and growing productive base, Ms. Lundsager said. Nevertheless, the authorities should accelerate somewhat their efforts in a number of areas with a view to increasing the domestic savings rate--which was negative at present--and to strengthening the external current account position over the medium term.

The public sector deficit had contracted dramatically over the previous several years, and an overall surplus was forecast for 1986, Ms. Lundsager noted. The adjustments that had been made in the middle of 1985 to offset earlier slippages were welcome, but the staff had recommended a strengthened revenue effort. In her view, greater emphasis should be placed on further containment of expenditure, as domestic revenue already was equivalent to some 33 percent of GDP, total expenditure some 41 percent, and current expenditure about 21 percent. Furthermore, given the authorities' interest in diversifying the productive base, any larger consumption of national resources by the Government could reduce incentives to private development and investment. Those issues could perhaps be addressed by the planned tax reform. The staff could usefully comment on the feasibility of achieving greater savings on current expenditure. The civil service wage increase projected for 1986 appeared to be less than the prevailing inflation rate and therefore should not be a cause for concern. She wondered whether there might be other areas where savings were feasible, including expenditure on goods and services, which had quadrupled over the previous four years.

The public enterprises played an extensive role in the productive sector and had been characterized by managerial difficulties and inefficiency, Ms. Lundsager commented. The authorities should consider encouraging the private sector to play a greater role in the production and marketing of the output that was currently produced by public enterprises. That effort could help to reduce further the overall deficit of the public enterprises, which still constituted some 5 percent of GDP. In his opening statement Mr. Rye had described some welcome developments in the Copra Board, and additional similar reforms would be helpful, including the privatization of commercial functions of other public entities.

The Copra Board had borrowed heavily in 1985 to sustain high domestic producer prices following a sharp drop in export prices, Ms. Lundsager noted. Producer prices had been lowered in November 1985 but apparently still remained above the export price. It was not clear to her precisely what course of action the authorities should take in the copra sector. They would certainly wish to maintain production if the drop in the export price was thought to be temporary, but it was possible that other producers were affecting the world's supply of copra and that the world demand for the product might be tapering off. In that event, subsidized production in Western Samoa could not be maintained over the long run. A comment on world developments in the copra sector and on the best course of action for the authorities in that area would be helpful.

Given the improved fiscal position, outstanding credit apparently could be contracted, Ms. Lundsager commented. Increases in credit to the private sector might have been excessive in the final months of 1985, as was reflected in the buildup of inventories of imported goods. Credit policy in 1986 should be cautious, and the authorities should broaden the range of monetary policy tools. Although interest rates appeared to be low in light of pricing developments--except perhaps the interest rate on savings--a more active interest rate policy could help to strengthen the payments position.

The authorities should continue their flexible management of the exchange rate, Ms. Lundsager considered. The staff had noted that that policy could counter the structural weakness in the economy. She agreed with the staff that appropriate price signals could help to promote the allocation of resources that was best suited to promoting growth in the long run.

Western Samoa's medium-term outlook probably appeared enviable in the eyes of many countries, Ms. Lundsager remarked. The tapering down of the debt burden would be particularly welcome, although as the staff had noted, a continued commitment to strong and comprehensive adjustment would be required if recourse to debt financing was to be avoided in the future. External grants had remained sizable--nearly equaling the external current account deficit--but it was risky to count on steady inflows from that source. Two bright spots in the external sector were tourism and remittances. If the domestic economy remained attractive, remittances could be particularly strong. That possibility underscored the crucial need to maintain appropriate macroeconomic and structural policies.

The authorities were to be commended for having reversed the fiscal deterioration that had begun in early 1985, Ms. Lundsager concluded. Their efforts had kept the medium-term adjustment effort on track. Maintaining that effort would help the favorable trends to continue and would avoid the emergence of payments difficulties while permitting a relaxation of the recently imposed trade restrictions. The proposed decision should be approved. The staff representative from the Asian

The staff representation from the Asian Department said that the staff considered that the 1986 budget that had been prepared by the new Government represented a considerable tightening of the fiscal stance compared with 1985. Still, there was some scope for further savings on current expenditure, although the Government had been implementing a strong policy of restraining growth of the number of civil servants and increases in wages and salaries. There also seemed to be further scope for reducing domestically financed development expenditure, which to some extent was similar to current expenditure.

It had been suggested by Mr. Rye that the staff was more pessimistic than the authorities about the prospects for the economy, the staff representative remarked. If there was any bias in the staff's projections, it was because of the cautious approach that the staff had taken in making its projections. That approach was appropriate for a country like Western Samoa, which was strongly influenced by international developments.

The project to extend the runway at the airport had been completed at the end of 1985, the staff representative noted. As a result, there had been a substantial increase in the number of visits by persons living abroad to their relatives in Western Samoa. That trend had been reflected in the increase in tourist receipts in 1985. However, it was still uncertain whether there would be a broadly-based expansion of tourism or the tourist sector. There was considerable potential for growth of the tourist sector in Western Samoa, but developments in that sector had been disappointing, and caution was called for in assessing the sector's future.

Copra apparently faced competition from substitutes, especially soybeans and other types of vegetable oils, and the prospects for copra exports were not encouraging, the staff representative from the Asian Department said. However, Western Samoa could not afford to eliminate its copra sector. The authorities appreciated the need to make greater policy efforts in general, and to take appropriate action with respect to pricing policy and exchange rate policy in particular.

Mr. Rye commented that it was important to bear in mind that the new Government had been in office only ten weeks. The Government had embarked on the correct policy path, but much remained to be done to translate the authorities' good intentions into actual achievements. Structural adjustments were required, and some of the groundwork needed for those changes had been prepared.

Ms. Lundsager's comments on copra were well taken, but, for the moment, the copra sector remained the mainstay of Western Samoa's economy, Mr. Rye remarked. Copra production responded rapidly to swings in prices, and the authorities' efforts to smooth out those swings were appropriate. In that connection, the main challenge was to try to discern how long the present sharp downward movement in the price of copra was likely to last. There was some potential for diversifying economic activity. The completion of the airport project opened up opportunities in addition to a possible increase in tourism: Western Samoa could conceivably develop further the production of such agricultural products as tropical fruit, which had to be transferred quickly to distant markets. Finally, given its stability and beautiful scenery, Western Samoa obviously had considerable potential for tourism.

The Chairman made the following summing up:

Executive Directors noted that Western Samoa's efforts to strengthen its economy had been sustained, and that the macroeconomic outturn in 1985 had been generally satisfactory. At the same time, recent developments had once more confirmed Western Samoa's vulnerability to external factors. Aggregate output expanded at a faster pace in 1985, inflation moderated further, and the external payments position remained manageable, despite a marked drop in the prices of the country's major exports. Directors also noted a re-emergence of demand pressures accompanied by a sharp increase in liquidity. They stressed the importance of financial restraint in order to alleviate these pressures and sustain medium-term economic adjustment.

Directors were of the view that a cautious budgetary policy was essential to restore financial restraint and to preserve economic balance in the face of a rapid deterioration in the terms of trade. Directors commended the authorities for the decisive expenditure restraint exhibited during the second half of 1985, which led to a substantial reduction in the overall deficit. They also welcomed the further tightening of fiscal policy envisaged in the draft budget for 1986. While stressing the need for continued efforts to curb public expenditure, however, Directors felt that the authorities should also step up their efforts to improve revenue mobilization and to review income tax regulations.

Directors expressed concern over the rapid expansion of liquidity in 1985, partly reflecting a strong increase in credit to the private sector. In this context, the recent reduction in producer prices and the planned reorganization of the Copra Board, including the privatization of its commercial operations, were welcomed. They stressed the importance of monetary policy in restraining aggregate expenditure, and welcomed the cautious credit policy stance envisaged for 1986. They welcomed the recent introduction of a minimum liquidity ratio for commercial banks, which would provide the Central Bank with an additional means of controlling liquidity. Directors considered that interest rate policy should be used actively and flexibly to mobilize domestic savings which, it was noted, were presently negative.

Notwithstanding the recent progress in economic adjustment, Directors considered that Western Samoa's current account deficit was still large and that the external payments outlook remained weak. It was stressed that continued adjustment efforts, particularly to strengthen production and exports, were essential to achieve a sustainable payments position over the medium term. Directors shared the view that such efforts should be supported by the maintenance of appropriate price incentives. In this context, the authorities were commended for their recent flexible management of the exchange rate and were encouraged to continue this stance.

While recognizing the difficult external circumstances faced by Western Samoa, Directors encouraged the authorities to replace direct import controls with appropriate macroeconomic policies aimed at controlling aggregate demand and strengthening production.

Directors commended the authorities for the recent success in reducing outstanding external debt and welcomed the authorities' intention to pursue a cautious borrowing policy that would limit external borrowing to the country's absorptive capacity and, where possible, to that available on concessional terms.

It is expected that the next Article IV consultation with Western Samoa will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Western Samoa's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1985 Article XIV consultation with Western Samoa, in the light of the 1985 Article IV consultation with Western Samoa conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Western Samoa continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV as described in SM/86/29. The advance deposit requirement for motor vehicle imports that was introduced in September 1985 constitutes a multiple currency practice subject to approval under Article VIII. The Fund urges the authorities to eliminate this multiple currency practice as soon as possible. In the circumstances of Western Samoa, the Fund grants approval for the maintenance of the multiple currency practice resulting from the advance deposit requirement until February 28, 1987, or the completion of the 1986 Article IV consultation with Western Samoa, whichever is earlier.

Decision No. 8212-(86/40), adopted
March 3, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/39 (2/28/86) and EBM/86/40 (3/3/86).

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/86/47 (2/27/86) is approved.

5. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/86/48 (2/28/86) is approved.

APPROVED: October 29, 1986

LEO VAN HOUTVEN
Secretary